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No. 06-1286

# In the Supreme Court of the United States

MICHAEL J. KNIGHT, TRUSTEE OF THE WILLIAM L. RUDKIN TESTAMENTARY TRUST, PETITIONER

*v.*

COMMISSIONER OF INTERNAL REVENUE

*ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT*

## BRIEF FOR THE RESPONDENT

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## QUESTION PRESENTED

Whether investment-advice fees incurred by petitioner, a trust, are costs "which would not have been incurred if the property were not held in such trust" within the meaning of 26 U.S.C. 67(e)(1).

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## BRIEF FOR THE RESPONDENT

### OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-19a) is reported at 467 F.3d 149. The opinion of the Tax Court (Pet. App. 20a-30a) is reported at 124 T.C. 304.

### JURISDICTION

The judgment of the court of appeals was entered on October 18, 2006. A petition for rehearing was denied on January 19, 2007 (Pet. App. 31a-32a). The petition for a writ of certiorari was filed on March 23, 2007, and was granted on June 25, 2007. The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

## STATUTORY PROVISIONS INVOLVED

The pertinent statutory provisions are set forth in an appendix to this brief. App., *infra*, 1a-5a.

## STATEMENT

1. Section 1 of the Internal Revenue Code imposes a tax on the "taxable income" of individuals and trusts. 26 U.S.C. 1 (2000 & Supp. IV 2004). The computation of taxable income begins with a determination of "gross income," which is defined as "all income from whatever source derived." 26 U.S.C. 61(a). Taxpayers can then subtract from gross income certain so-called "above-the-line" deductions, such as trade and business expenses, losses from the sale or exchange of property, and deductions attributable to rents and royalties, to arrive at "adjusted gross income." 26 U.S.C. 62(a) (2000 & Supp. IV 2004). Taxable income is calculated by subtracting from adjusted gross income "itemized," or "below-the-line," deductions, consisting of all deductions other than above-the-line deductions and the deduction for personal exemptions. 26 U.S.C. 63 (2000 & Supp. IV 2004).

In the case of individuals, 26 U.S.C. 67(b) defines a subset of itemized deductions called "miscellaneous itemized deductions," which are deductible "only to the extent that the aggregate of such deductions exceeds 2 percent of adjusted gross income," 26 U.S.C. 67(a). That limitation was imposed by the Tax Reform Act of 1986, Pub. L. No. 99-514, § 132(a), 100 Stat. 2113, and it is often referred to as the "2% floor." Fees paid for investment advice are deductible under 26 U.S.C. 212, which allows deductions for ordinary and necessary expenses paid or incurred in producing income and in managing property held for the production of income. See 26 C.F.R. 1.212-1(g). Such fees constitute miscellaneous

itemized deductions that are subject to the 2% floor. See 26 C.F.R. 1.67-1T(a)(1)(ii).

The 2% floor applicable to individuals also applies to trusts, with limited exceptions.[1] Under 26 U.S.C. 67(e), "the adjusted gross income of an estate or trust shall be computed in the same manner as in the case of an individual, except that—(1) the deductions for costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate * * * shall be treated as allowable" notwithstanding the 2% floor.

2. Petitioner is a multi-generational trust that was established in 1967 under the will of Henry A. Rudkin, Sr., and was funded with proceeds from the sale of the Pepperidge Farm baked-goods company to the Campbell Soup Company. Pet. App. 21a. The beneficiaries are Henry's son, William, and William's descendants. *Id.* at 21a, 35a-36a. The will gives petitioner's fiduciaries broad powers to invest petitioner's assets, and it authorizes them to obtain outside advice in making those investments. *Id.* at 21a-22a, 38a, 41a.

During 2000, petitioner held between $2.2 million and $3.4 million in marketable securities, and it paid Warfield Associates, Inc. (Warfield), $22,241 for investment-management advice. Pet. App. 22a; J.A. 12-27. On its fiduciary income tax return for 2000, petitioner reported total income of $624,816, and it deducted, in full, the fees that it had paid to Warfield for investment advice. Pet. App. 3a, 22a-23a; J.A. 12. After an audit, the Commissioner allowed petitioner to deduct the investment-

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[1] The statute applies equally to trusts and to estates. For convenience, and because petitioner is a trust, this brief will refer solely to trusts.

advice fees only to the extent that they exceeded 2% of petitioner's adjusted gross income, resulting in a tax deficiency of $4448. Pet. App. 3a, 22a.

3. Petitioner sought review of the asserted deficiency in the Tax Court. At trial, petitioner appeared through its trustee, Michael J. Knight, a certified public accountant. Knight discussed petitioner's practices but did not testify under oath. Knight did not present any evidence regarding petitioner's investment objectives or his qualifications and ability to achieve those objectives. The record also lacks evidence about Warfield and its schedule of fees for investment-management advice. See J.A. 10-11 (stipulation of facts).

Petitioner relied on *O'Neill* v *Commissioner*, 994 F.2d 302 (1993), rev'g 98 T.C. 227 (1992), nonacq., 1994-2 C.B. 1, in which the Sixth Circuit held that investment-management fees paid by a trustee are covered by the exception in Section 67(e)(1). The *O'Neill* court reasoned that because a trustee has a fiduciary duty under state law to manage assets prudently, fees for investment advice are necessary to the trust's administration. Although individual investors can incur similar costs, "they are not *required* to consult advisors and suffer no penalties or potential liability if they act negligently for themselves." *Id.* at 304.

In response, the Commissioner cited *Mellon Bank, N.A.* v. *United States*, 265 F.3d 1275 (2001), aff'g 47 Fed. Cl. 186 (2000), in which the Federal Circuit rejected *O'Neill* and held that expenses are fully deductible only if they are "unique to the administration of a trust and not customarily incurred outside of trusts." *Id.* at 1281. Since investment advice and management fees "are commonly incurred outside of trusts," the Federal Circuit concluded, they are not covered by Section

67(e)(1) and are subject to the 2% floor. *Ibid.* The Fourth Circuit has reached a similar conclusion. See *Scott* v. *United States*, 328 F.3d 132, 140 (2003) ("Because investment-advice fees are commonly incurred outside the context of trust administration, they are subject to the 2% floor created by [Section] 67(a)."), aff'g 186 F. Supp. 2d 664 (E.D. Va. 2002).

4. The Tax Court, in a reviewed decision, unanimously upheld the deficiency. Pet. App. 20a-30a. It concluded that the construction of Section 67(e) that it had set forth in *O'Neill* v. *Commissioner*, 98 T.C. 227, 230-231 (1992), rev'd 994 F.2d 302 (6th Cir. 1993), nonacq. 1994-2 C.B. 1, "remain[ed] sound." Pet. App. 29a. The Tax Court rejected the Sixth Circuit's approach, explaining that because anything a trustee does in connection with the administration of a trust is arguably in furtherance of his or her fiduciary duty, petitioner's argument would make all administrative expenses fully deductible and would render the second clause of Section 67(e)(1) superfluous. *Id.* at 28a-29a. The Tax Court thus agreed with the Commissioner that Section 67(e)(1) allows full deductibility only for expenses that are not commonly incurred outside of the trust setting. *Id.* at 26a-29a. Because investment-advice fees are commonly incurred by individuals in managing their own investments, the Tax Court held that they are subject to the 2% floor. *Id.* at 27a, 30a.

5. The court of appeals affirmed. Pet. App. 1a-19a. The court rejected the Sixth Circuit's position on the question presented, and ultimately reached the same result as the Fourth and Federal Circuits, although on the basis of different reasoning. Consistent with the analysis of the Fourth and Federal Circuits, the court of appeals explained that "the statutory language directs

the inquiry toward the counterfactual condition of assets held individually instead of in trust," but it "does not require a subjective and hypothetical inquiry into whether a particular, individual asset owner *would* have incurred the particular cost at issue." *Id.* at 11a. Instead, "the statute sets an objective limit on the availability of a full deduction." *Id.* at 12a. "[A]s the source of that limit," the court continued, Section 67(e)(1) "looks to those costs that individual property owners are capable of incurring." *Ibid.* In the court's view, "the plain text of [Section] 67(e) requires that we determine with certainty that costs could not have been incurred if the property were held by an individual." *Ibid.* The court therefore held "that the plain meaning of the statute permits a trust to take a full deduction only for those costs that could not have been incurred by an individual property owner." *Id.* at 12a-13a. Because the investment-advice fees at issue were costs that individuals could incur, those fees were held to be subject to the 2% floor even though they were incurred by a trust in the course of its administration. The court explained that its analysis differed from that of the Fourth and Federal Circuits because it did not require an inquiry into whether a given cost is "*customarily*" or "*commonly*" incurred by individuals. *Id.* at 12a.

6. On July 27, 2007, the Internal Revenue Service (IRS) issued a proposed Treasury regulation interpreting Section 67(e). See Prop. Treas. Reg. 1.67-4, 72 Fed. Reg. 41,245. The proposed regulation is consistent with the reasoning of the court of appeals and provides that a cost is not subject to the 2% floor if it is "unique" to a trust. Prop. Treas. Reg. 1.67-4(a), 72 Fed. Reg. at 41,245. A cost is "unique" to a trust "if an individual could not have incurred that cost in connection with

property not held in [a] * * * trust." Prop. Treas. Reg. 1.67-4(b), 72 Fed. Reg. at 41,245.

The IRS will hold a public hearing on the proposed regulation on November 14, 2007. 72 Fed. Reg. at 41,245. If the regulation is adopted as proposed, it will be prospective in effect, governing all payments made after its publication. Prop. Treas. Reg. 1.67-4(d), 72 Fed. Reg. at 41,245; see generally 26 U.S.C. 7805(b); cf. *Smiley* v. *Citibank (S.D.) N.A.*, 517 U.S. 735, 744 n.3 (1996) ("Where * * * a court is addressing transactions that occurred at a time when there was no clear agency guidance, it would be absurd to ignore the agency's current authoritative pronouncement of what the statute means.").

## SUMMARY OF ARGUMENT

Under 26 U.S.C. 67(a), trusts, like individuals, may claim miscellaneous itemized deductions only to the extent that those deductions exceed 2% of adjusted gross income. Section 67(e)(1) creates a limited exception for costs that are paid "in connection with the administration of" a trust and that "would not have been incurred if the property were not held in such trust." 26 U.S.C. 67(e)(1). As this Court has repeatedly held, such exceptions to a general rule of taxability must be narrowly construed. The court of appeals correctly held that investment-advice fees do not qualify for that narrow exception.

Considered in the abstract, there are three linguistically permissible interpretations of the phrase "costs * * * which would not have been incurred if the property were not held in such trust." The phrase could be understood (1) to require an individualized assessment of the hypothetical question whether the specific individual(s) who would have been in possession of the particu-

lar property but for the existence of the trust would have incurred the specific cost at issue; (2) to encompass only those costs that definitely would not have been incurred absent a trust, *i.e.*, costs that individuals simply do not incur; or (3) to apply to those costs that individuals do not customarily or commonly incur. The first interpretation is not urged by any party, has not been adopted by any court, and must be rejected because it would be hopelessly vague, unworkable, and burdensome for trusts, the IRS, and the courts alike. There is no indication that Congress intended that wholly unworkable result. Rather, in keeping with the statutory text, the proper focus is on the nature of the cost at issue, not the (entirely speculative) particular factual circumstances of the (often unknowable) individual(s) who "would have" possessed the assets at issue in the absence of a trust.

Under either one of the remaining two linguistically permissible interpretations of the "would not have been incurred" clause, investment-advice fees are not covered by Section 67(e)(1). First, as the court of appeals here reasoned, the statute is best read to require certainty that the costs at issue would not have been incurred outside of a trust. Only costs that are unique to trusts can be confidently excluded from the expenses individuals would incur without a trust. As a result, it follows that Section 67(e)(1) does not exempt from the 2% floor any costs that could have been incurred by individuals. Petitioner errs in suggesting that the court of appeals impermissibly substituted "could" for "would" in the statute. Rather, the inquiry into expenses unique to trusts is inevitable once the focus shifts from an utterly unworkable counterfactual attempt to determine what expenses a beneficiary would have incurred if it were

not a trust, to a workable and generalized inquiry. Only if individuals by definition do not incur a particular type of cost experienced by trusts is it possible to conclude with assurance that the cost "would not have been incurred if the property were not held in such trust or estate."

Alternatively, as the Fourth and Federal Circuits have concluded, "would" may be understood to refer to what is customary or common, and thus Section 67(e) does not encompass costs that are commonly incurred by individuals. The first construction is preferable because it makes the statute significantly more administrable, but under either reading, investment-advice fees do not qualify. Individuals can—and commonly do—incur such fees with respect to assets that are held outside of a trust, and petitioner offered no evidence to the contrary.

Petitioner contends that Section 67(e) imposes a weak "causation" test under which costs that are caused in some sense by the trustee's exercise of fiduciary responsibilities are exempt from the 2% floor. But the statute's text imposes no such weak causal test. Far from examining the nature of the cost at issue from the perspective of whether it was caused by the trustee's duties, the statute instead looks to the counterfactual question of whether *individuals* would have incurred such costs in the *absence* of a trust—and prudent individuals may well incur the very same costs that a prudent trustee would be motivated to incur in furtherance of the trustee's fiduciary obligations.

Moreover, petitioner's weak causation test must be rejected because it would deprive the "would not have been incurred" clause of any effect. Petitioner's test at most captures the universe of costs subject to potential

deduction before consideration of the "would not have been incurred" clause. If the trustee is acting in good faith, all costs associated with trust administration are incurred in the exercise of the trustee's fiduciary duty, and thus all such costs would be exempt under petitioner's approach. But Section 67(e) clearly provides that deductions are exempt from the 2% floor only if they are incurred in connection with trust administration *and* would not have been incurred absent a trust. Moreover, to the extent that petitioner's rule requires identification of the causes of a particular trustee's decision to incur a particular cost, it is unworkable in practice and would result in inconsistent treatment of the same costs from trust to trust.

Finally, petitioner advances various arguments based on legislative history and policy considerations. The decision of the court of appeals is entirely consistent with the legislative history, which shows that one of Congress's goals in enacting the 2% floor was to reduce abuses, an objective that is advanced by applying the 2% floor to trust investment-advice fees. And, contrary to petitioner's suggestion, there is no reason to believe that the rule adopted by the court of appeals will lead trustees to neglect their fiduciary duty by failing to seek investment advice when such advice is needed.

## ARGUMENT

### SECTION 67(e) OF THE INTERNAL REVENUE CODE DOES NOT PERMIT A FULL DEDUCTION FOR THE COST OF INVESTMENT MANAGEMENT AND ADVISORY SERVICES PROVIDED TO TRUSTS AND ESTATES

#### A. Under 26 U.S.C. 67(e)(1), Costs Incurred By A Trust Are Exempt From The 2% Floor Only If They Are Not Costs Of A Type That Individuals Incur

##### *1. Section 67(e)(1) looks to the conduct of individuals outside the context of trusts to determine whether an expense is subject to the 2% floor*

The introductory text of 26 U.S.C. 67(e) establishes the general policy that "the adjusted gross income of an estate or trust shall be computed in the same manner as in the case of an individual." Under that general policy, deductions for investment-advice fees—whether incurred by trusts or by individuals—are treated as miscellaneous itemized deductions subject to the 2% floor of 26 U.S.C. 67(a).[2] Section 67(e)(1) then creates a limited

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[2] Petitioner advances various arguments (Br. 26-27, 30-31) based on the treatment of trust expenses before 1986. But the 2% floor did not exist until 1986, so the different treatment of trust expenses before 1986 sheds no light on the proper interpretation of 26 U.S.C. 67. Nor is there any merit to the argument of amicus curiae the Florida Bar (Br. 6-7, 25-26) that 26 U.S.C. 212 and 26 U.S.C. 2053 (2000 & Supp. IV 2004) control the application of 26 U.S.C. 67(e). Section 212 (along with 26 C.F.R. 1.212-1(d)) is in no way a "parent statute" to Section 67(e), but instead stands for the unremarkable proposition that expenses ostensibly incurred for the production, collection, or management of income outside of a trade or business must have a proximate relation to that purpose to be deductible at all. There is no dispute that the costs of investment advice at issue here satisfy the requirements of Section 212. While Section 2053(a) (along with 26 C.F.R. 20.2053-3) allows the

exception to that general policy, allowing specified costs that qualify for the exception to be deducted in full in computing adjusted gross income.

"In construing provisions * * * in which a general statement of policy is qualified by an exception, we usually read the exception narrowly in order to preserve the primary operation of the provision." *Commissioner* v. *Clark*, 489 U.S. 726, 739 (1989). That is doubly true of Section 67(e)(1), because it confers a deduction that would otherwise be unavailable. See *INDOPCO, Inc.* v. *Commissioner*, 503 U.S. 79, 84 (1992) ("an income tax deduction is a matter of legislative grace and * * * the burden of clearly showing the right to the claimed deduction is on the taxpayer") (citation omitted); *New Colonial Ice Co.* v. *Helvering*, 292 U.S. 435, 440 (1934) ("Whether and to what extent deductions shall be allowed depends upon legislative grace; and only as there is clear provision therefor can any particular deduction be allowed."); see also *United States* v. *Centennial Sav. Bank FSB*, 499 U.S. 573, 583 (1991) (applying "the rule that tax-exemption and -deferral provisions are to be construed narrowly"). Any ambiguity in the scope of the exception created by Section 67(e)(1) must therefore be resolved in favor of the general rule that trusts are to be taxed in the same manner as individuals: "Given that Congress has enacted a general rule * * *, we should not eviscerate that legislative judgment through an expansive reading of a somewhat ambiguous exception." *Clark*, 489 U.S. at 739.

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deduction of certain administrative expenses in calculating a decedent's taxable estate subject to the *estate* tax, see 26 U.S.C. 2001 (2000 & Supp. IV 2004), that has no bearing on the unrelated *income* tax question at issue here.

Section 67(e)(1) establishes two requirements for expenditures to qualify for the exception. The first requirement is set forth in the first clause of Section 67(e)(1), which states that the costs must be those "which are paid or incurred in connection with the administration of the estate or trust." 26 U.S.C. 67(e)(1). That clause "defines the relationship between the costs and the administration of the trust," *Mellon Bank*, 265 F.3d at 1280, by separating trust-related administrative expenses from other types of expenses that a trust might incur. There is no dispute that fees for investment advice satisfy that clause.

The second requirement is set forth in the second clause of Section 67(e)(1), which provides that the costs must be those "which would not have been incurred if the property were not held in such trust or estate." 26 U.S.C. 67(e)(1). In keeping with the plain meaning of the text and the canon that statutes should be interpreted to give effect to all their terms, the second clause does not simply separate trust-related administrative costs from other types of expenses, because the first clause has already done that. Cf. *Cooper Indus., Inc.* v. *Aviall Servs., Inc.*, 543 U.S. 157, 166-167 (2004); *Duncan* v. *Walker*, 533 U.S. 167, 174 (2001). Instead, the second clause must be understood as a "filter" for determining the *subset* of trust-related administrative costs that are exempt from the 2% floor. *Scott*, 328 F.3d at 140; *Mellon Bank*, 265 F.3d at 1280-1281. In particular, the statute as a whole seeks to identify only those trust-related expenses that would *not* have been incurred in the counterfactual world in which no trust was created. Because in reality, a trust was created, this text provides an interpretive challenge.

Considered in the abstract, there are three linguistically permissible interpretations of the critical phrase "costs * * * which would not have been incurred if the property were not held in such trust." The phrase could be understood (1) to require an individualized assessment of the hypothetical question whether the specific individual(s) who would have been in possession of the particular property but for the existence of the trust would have incurred the specific cost at issue; (2) to encompass only those costs that definitely would not have been incurred absent a trust, *i.e.*, costs that individuals simply do not incur; or (3) to apply to those costs that individuals do not customarily or commonly incur.

The first interpretation is not urged by any party, has not been adopted by any court, and should be rejected out of hand. If Section 67(e)(1) were read to necessitate an individualized assessment of each cost incurred by each trust in light of the unique circumstances of the grantor(s) and beneficiary(ies) in an effort to predict hypothetical outcomes in the absence of a trust, it would be hopelessly vague and administratively unworkable, and would impose substantial burdens and inefficiencies on trusts, the IRS, and the courts.

As an initial matter, it is unclear how the relevant decision-maker (whether a trustee seeking to determine the deductibility of a cost, the IRS auditing a trust return, or a court attempting to resolve a dispute) would even go about determining who would have held the trust's assets if the trust did not exist. The assets might have been held by the grantor (if living) or the grantor's heirs, by some or all of the trust beneficiaries, by the trustee, or by some third party. And some of those multiple potential holders of the assets in the hypothetical no-trust world would presumably have been more likely

than others to incur the costs at issue, further complicating an already hopelessly speculative predictive effort.

On the facts of this case, for example, there is no satisfactory way to identify with accuracy the hypothetical asset-holder(s) in the counterfactual no-trust world, which would seem to be a necessary first step in making the speculative individualized prediction whether one, some, or all of such hypothetical person(s) in particular would have incurred investment-advisory fees in that counterfactual world. Nor is there any principled basis for determining precisely how such hypothetical person or persons would have acted in the hypothetical counterfactual world; all that can be determined with any confidence is that such person(s) would *not* have incurred any costs of a type that individuals do not (because they cannot) incur.

As the court of appeals observed, "[n]othing in the statute indicates that Congress intended the test for the exception to the two-percent floor to give rise to factual disputes about whether an individual asset owner (or owners) is insufficiently financially savvy or the assets sufficiently large such that he or she unquestionably would have sought investment advice." Pet. App. 11a. Making the deductibility of investment advice turn on the complexity of a trust's finances and the financial acumen of the unknown (and unknowable) person(s) who would have held the assets in the speculative no-trust world would needlessly multiply administrative and judicial proceedings by requiring a detailed analysis of each trust and its grantors, trustees, and beneficiaries (among others), and it would result in inconsistent treatment of the same costs from trust to trust.

Instead, as the court of appeals recognized, the phrase "such trust" in the second clause "is best under-

stood as referring to the generic trust of [Section] 67(e)'s introductory language and not to any actual, particular trust that incurred a cost subject to scrutiny." Pet. App. 13a. Thus, the reference to a generic trust or estate keeps the analysis focused on the type of cost at issue, not on the idiosyncracies of the trust that happened to incur it. Unlike the first clause, which is in the indicative mood, the second clause employs the subjunctive mood, and thus describes a condition that is hypothetical or contrary to fact. The second clause does not ask what in fact happened; rather, it asks whether something (namely, the incurrence of a cost) *would not* have happened if a trust had not existed. As the court of appeals explained, the clause "focuses the inquiry * * * on the hypothetical situation where the assets are in the hands of an individual." *Id.* at 11a. See *Scott*, 328 F.3d at 140; *Mellon Bank*, 265 F.3d at 1280-1281; Prop. Treas. Reg. 1.67-4(b), 72 Fed. Reg. at 41,245 ("In making this determination, it is the type of product or service rendered to the estate or trust * * * that is relevant."). Courts cannot make factual inquiries into hypothetical and counterfactual circumstances. Accordingly, the text must call for a more categorical and legal treatment of trust expenses. The statute "does not require a subjective and hypothetical inquiry into whether a particular, individual asset owner *would* have incurred the particular cost at issue." Pet. App. 11a. Section 67(e)(1) should instead be construed to mandate a generalized inquiry regarding the type of cost at issue.

### 2. *Section 67(e)(1) is best read to exempt from the 2% floor only those costs that individuals do not incur absent a trust*

Once the individualized-assessment approach is rejected as entirely impracticable, two linguistically permissible interpretations remain for consideration. Under Section 67(e)(1), only those costs paid in connection with the administration of a trust that "would not have been incurred if the property were not held in such trust" are exempted from the 2% floor imposed by 26 U.S.C. 67(a). In common parlance, the phrase "would not have" can be used either to indicate something that definitely would not have occurred, or something that would not commonly or customarily have occurred. Either definition provides the basis for a permissible reading of the statute, but the former is preferable because it makes the statute significantly easier to administer.

a. The court of appeals held that Section 67(e)(1) "permits a trust to take a full deduction only for those costs that could not have been incurred by an individual property owner." Pet. App. 13a. The proposed Treasury regulation would likewise limit full deductibility to costs that are "unique" to trusts and estates, explaining that "a cost is unique to an estate or a non-grantor trust if an individual could not have incurred that cost in connection with property not held in an estate or trust." Prop. Treas. Reg. 1.67-4(a) and (b), 72 Fed. Reg. at 41,245. That position represents the best reading of the statutory text.

Petitioner contends (Br. 45) that the court of appeals and the proposed Treasury regulation err because they read "would" to mean "could," and "'[w]ould' simply does not mean 'could.'" Petitioner is mistaken. Contrary to petitioner's characterization, the court of ap-

peals (like the proposed regulation) did not simply substitute "could" for "would" in the same sentence. Instead, the court analyzed the grammar and structure of Section 67(e) and concluded that the second clause of Section 67(e)(1), which employs the phrase "would not" in conjunction with another instance of the word "not," carried essentially the same meaning as a sentence employing the word "could" without the use of the double negative. That interpretation appropriately takes account of the statutory structure and context. Cf. *National Ass'n of Home Builders* v. *Defenders of Wildlife*, 127 S. Ct. 2518, 2534 (2007); *Dolan* v. *USPS*, 546 U.S. 481, 486 (2006). Moreover, one reason that a cost would not be incurred in certain circumstances is that it could not be incurred. And since the statutory text asks whether an expense would have been incurred in a counterfactual no-trust scenario—but does not expressly specify the degree of certainty required in answering that hypothetical question—it is open to a construction that includes only those expenses that could not have been incurred.

Section 67(e) provides that trusts must compute their income in the same way as individuals, except that they can fully deduct trust-related administrative costs that would not have been incurred by individuals outside the context of trust administration. Rephrasing the exception to reflect that "would" is the past tense of "will," see *Webster's Third New International Dictionary of the English Language* 2637 (1986) (*Webster's*), trusts can fully deduct only those trust-related administrative costs that will not be incurred by individuals outside the context of trust administration. As the court of appeals explained, "the plain language of the statute requires certainty that a particular cost 'would not have been in-

curred' if the property were not held in trust." Pet. App. 11a. And the only way to be certain that trusts will not take full deductions for costs that individuals must place under the 2% floor is to limit full deductibility to those costs that individuals are incapable of incurring. See *id.* at 11a-12a.

That interpretation reflects and is confirmed by the commonsense understanding that to say something "would not" have occurred in the absence of a certain state of affairs is a categorical negation of the possibility that it would have occurred. For example, to say that a team would not have won the game if it were not for the quarterback's outstanding play is to say that the team could not have won without the quarterback. The statutory question is not (as petitioner apparently would have it) whether the cost "might not" or "probably would not" have been incurred absent a trust, or whether it is "more likely than not" that the cost would have been avoided in that circumstance. Rather, the phrase "would not have been incurred" implicitly demands certainty that the cost would not have been incurred absent a trust. Only if individuals by definition cannot incur a particular type of cost experienced by trusts—*i.e.*, the costs are unique to trusts—is it possible to conclude with assurance that the cost "would not have been incurred if the property were not held in such trust or estate."

The same conclusion follows from parsing the logical structure of the second clause. For a cost to escape the 2% floor, it must be a cost "which would not have been incurred *if* the property were not held in such trust." 26 U.S.C. 67(e) (emphasis added). Thus, the second clause explicitly has an antecedent (an "if" statement) and implicitly has a consequent (a "then" statement). Rephrasing the provision to place the antecedent and the conse-

quent in the usual order yields "if the property were not held in trust, then the cost would not have been incurred." The statement "if not A then not B" is the logical equivalent of "B only if A." Irving M. Copi & Carl Cohen, *Introduction to Logic* 357-364, 403-404 (10th ed. 1998). Thus, the reordered statutory sentence is the logical equivalent of the proposition that "the cost would be incurred only if the property is held in trust." The only costs for which that statement is always true are those that could not be incurred outside of trusts. And that brings the analysis back to the court of appeals' correct holding that "the plain meaning of the statute permits a trust to take a full deduction only for those costs that could not have been incurred by an individual property owner." Pet. App. 13a.[3]

b. Alternatively, the word "would" in Section 67(e)(1) can be understood to express "disposition or inclination" or "custom or habitual action." *Webster's* 2638. Under that approach, adopted by the Fourth and Federal Circuits, the second clause of Section 67(e)(1) treats as fully deductible only those trust-related administrative expenses that are not customary or inclined to occur outside of the context of trusts. See *Scott*, 328 F.3d at 140; *Mellon Bank*, 265 F.3d at 1280-1281.

Petitioner asserts (Br. 47) that this definition of "would" is "obviously" not the sense in which the word is used in the statute. But since the statute requires an

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[3] Petitioner contends (Br. 45) that this interpretation makes the first clause of Section 67(e)(1) superfluous, because the only costs that an individual could not incur are those "paid or incurred in connection with the administration of the trust." The first clause is not superfluous, however, because it removes from consideration non-administrative costs—such as losses from bad debts—so that they need not be evaluated under the second clause, thus making the statute clearer and easier to apply.

examination of the counterfactual situation in which assets are not held in trust, it is entirely reasonable to conduct that inquiry by considering the customary or natural ways in which individuals may provide for the management of assets under such circumstances. In context, that is a permissible and natural reading of the word "would."

c. As explained above, there are essentially three possible ways of identifying costs that would not have been incurred in the absence of a trust. The individualized approach founders at the necessary first step of identifying the relevant taxpayer in the non-trust world, and is in all events hopelessly unadministrable. Although either of the other two interpretations would be reasonable and consistent with the statute, the interpretation adopted by the court of appeals is the best reading of the text and offers the most administrable approach.[4] Under that interpretation, application of the 2% floor turns simply upon whether an individual could incur a particular expense. It thereby avoids needless disputes such as those petitioner seeks to raise here (Br. 48-50). For example, that interpretation makes it unnecessary to decide how to determine the relevant population in which the expense must be "common" (for example, all citizens, all taxpayers, or all taxpayers who satisfy certain criteria), or what fraction of that population must incur an expense before an expense is considered "common." More importantly, it eliminates any

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[4] Petitioner errs in claiming (Br. 44) that the Commissioner has "abandoned" the position embraced by the Fourth and Federal Circuits. As discussed above, both positions represent permissible interpretations of the statute. In any event, both tests will yield the same result in almost all cases. See pp. 24-28, *infra*.

need to hold a trial to determine what fraction of the population actually incurs the expense.

Because the interpretation adopted by the court of appeals is faithful to the statute and easier to administer than the standard adopted by the Fourth and Federal Circuits, the judgment of the court of appeals should be affirmed. Indeed, assuming that the standard set forth in the proposed Treasury regulation is adopted as a final regulation, that standard, being a reasonable interpretation of Section 67(e), would be upheld under the deferential review afforded to administrative interpretations of the Internal Revenue Code.[5] See *Boeing Co.* v. *United States*, 537 U.S. 437, 448 (2003); *Chevron USA Inc.* v. *NRDC*, 467 U.S. 837 (1984).[6]

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[5] As noted, the statute asks a court to determine whether an expense would have been incurred if, contrary to fact, a trust was not formed, without expressly stating the degree of confidence that a court must have that the expense would not be incurred. The best view is that an unmodified reference to an expense that would not have been incurred implicitly demands certainty that the cost would not be incurred. Congress could have made that explicit with a modifier like "definitely." The Fourth and Federal Circuit approach, by contrast, essentially adds the modifier "commonly" or "customarily" to "would not." If there is any ambiguity as to whether the statute captures expenses that definitely would not have been incurred or instead those that commonly would not have been incurred, that ambiguity should be resolved in favor of the IRS's favored approach, either through principles of deference or through application of the canons favoring narrow construction of deductions and exceptions. See p. 12, *supra*.

[6] Petitioner errs in relying (Br. 49 n.33) on *National Muffler Dealers Ass'n* v. *United States*, 440 U.S. 472 (1979), to argue that the proposed Treasury regulation would be entitled to a lesser standard of deference than that required under *Chevron*. Under 26 U.S.C. 7805(a), the Secretary of the Treasury has the authority to "prescribe all needful rules and regulations for the enforcement of" the Internal Revenue Code. Regulations issued under that authority are entitled to *Chevron* deference to the same extent as regulations issued by any other federal

### B. Investment-Advice Fees Are Subject To The 2% Floor Because They Can Be—And Commonly Are—Incurred By Individuals

As discussed, Section 67(e)(1) can reasonably be interpreted in two slightly different ways, each of which establishes an objective test that focuses on the nature of a trust-related administrative cost when deciding whether it is subject to the 2% floor. While the court of appeals' test—like that embraced by the IRS in the proposed Treasury regulation—is somewhat "more restrictive" (Pet. App. 12a) than the test adopted by the Fourth and Federal Circuits, both tests produce the same result when applied to typical trust expenses.

1. There is no dispute that costs paid or incurred for fiduciary accountings, judicial filings required as part of trust administration, the preparation and filing of fiduciary income tax returns, trust construction proceedings, fiduciary bond premiums, or communications with beneficiaries would all escape the 2% floor. All of those expenses are unique to trust administration; they are expenses that individuals cannot incur. See Pet. App. 12a; *Scott*, 328 F.3d at 140; Prop. Treas. Reg. 1.67-4(b), 72 Fed. Reg. at 41,245.[7]

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agency. See *United States* v. *Boyle*, 469 U.S. 241, 246 n.4 (1985); see also *United States* v. *Mead Corp.*, 533 U.S. 218, 229 (2001) (regulations are entitled to *Chevron* deference if issued under an agency's "generally conferred authority * * * to speak with the force of law"); *National Cable & Telecomms. Ass'n* v. *Brand X Internet Servs.*, 545 U.S. 967, 980 (2005) (applying *Chevron* to regulations issued by the FCC under its authority "to 'execute and enforce' the Communications Act and to 'prescribe such rules and regulations as may be necessary in the public interest to carry out the provisions' of the Act") (quoting Communications Act of 1934, 47 U.S.C. 151, 201(b)).

[7] The proposed regulation would require the unbundling of unitary fees so that only costs unique to estates and trusts escape the 2% floor.

2. Investment-advice fees are different. Unlike the costs illustrated above, which are unique to trust administration, the cost of third-party investment advice can be and often is incurred by individuals in managing their own affairs outside the context of trust administration. As the court of appeals noted, the fact that investment-advice fees are subject to the 2% floor under 26 C.F.R. 1.67-1T(a)(1)(ii) (a regulation applicable to individuals) demonstrates that individuals are capable of incurring those fees. Pet. App. 12a. The proposed Treasury regulation also lists other products and services that are subject to the 2% floor, including the costs associated with the custody or management of property, gift tax returns, the defense of creditor claims, and the purchase, sale, maintenance, repair, insurance, or management of non-business property. Prop. Treas. Reg. 1.67-4(b), 72 Fed. Reg. at 41,245. All the items on that list are costs that individuals can, and commonly do, incur.[8]

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Prop. Treas. Reg. 1.67-4(c), 72 Fed. Reg. at 41,245. The proposed regulation would categorize the most common trust expenses as falling above or below the floor, and a taxpayer could use "any reasonable method" to make the necessary allocation. *Ibid.* The IRS, moreover, has "invite[d] comments on whether any safe harbors or other guidance, concerning allocation methods or otherwise, would be helpful." 72 Fed. Reg. at 41,244. Thus, petitioner is mistaken in contending (Br. 40-41) that the test established by the proposed regulation would result in the placement of all trust expenses below the floor, or (Br. 46) that the requisite unbundling would impose an "insurmountable" administrative hurdle. Likewise, petitioner is incorrect when it contends (Br. 44 n.32) that "trustee fees" are per se deductible, "even though they primarily purchase investment management services." The proposed regulation does not specifically address trustee fees, and they would be subject to its general unbundling requirement.

[8] Petitioner asserts (Br. 42) that the current version of Form 1041, the income tax return for trusts and estates, indicates that attorney and accountant fees are fully deductible. Depending on the nature of those

Petitioner errs in arguing that the proposed Treasury regulation allows the deduction of costs for some types of investment advice. According to petitioner (Br. 42 n.30), "the Commissioner's latest proposal is that only fees for 'advice on investing for total return,' are subject to the two-percent floor." That is a misreading of the proposed regulation. The treatment of trust costs under the proposed regulation turns on whether an individual could have incurred the cost in connection with property not held in trust. See Prop. Treas. Reg. 1.67-4(b), 72 Fed. Reg. at 41,245. Advice on "investing for total return" is one example in the list of items subject to the 2% floor, but that list is expressly described as "non-exclusive." *Ibid.* Notably, no form of investment advice appears on the list of products or services that escape the floor. Of course, if an investment advisor were to impose a special, additional charge applicable only to its fiduciary accounts, that would be a charge that an individual account holder could not have incurred, and a trust would be entitled to unbundle that "unique" charge and take a full deduction for it. See Prop. Treas. Reg. 1.67-4(c), 72 Fed. Reg. at 41,245.

Petitioner contends (Br. 42) that the decision below and the proposed Treasury regulation employ an "inappropriately broad level of generality" to describe investment-advice fees, while "more narrowly" describing costs that are not subject to the 2% floor. Described at the broadest possible level of generality, all expenses would be incurred by individuals and therefore would be subject to the 2% floor. Conversely, if trust expenses are viewed through the narrowest possible lens as hav-

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fees, they may well be deductible under the regulation. Once the proposed regulation has become final, the IRS will presumably modify the form as appropriate to reflect the provisions of the regulation.

ing been "caused" by the existence of the trust (as petitioner would have it), then none of those expenses would have been incurred by individuals (who by definition do not incur expenses for trust administration). Neither approach constitutes a sensible application of a statute that is meant to exempt some, but not all, expenses from the 2% floor. Contrary to petitioner's suggestion, the test adopted by the court of appeals—and reflected in the proposed regulation—calls for a reasonable, commonsense characterization of the expenses.

Petitioner's objection to the characterization of investment advice rests on the premise (Br. 3, 22-23) that investment advice sought by trustees is always "different in kind" from the similar advice sought by individuals, and for that reason should be subject to a different rule. That premise is incorrect. Under the prudent-investor standard, a trustee, in attempting to accomplish the goals of the trust, must act "as a prudent investor would" in attempting to accomplish the same goals. Restatement (Third) of Trusts (Prudent Investor Rule) § 227, at 8 (1992); see Uniform Prudent Investor Act § 2(a), 7B U.L.A. 20 (2006) ("A trustee shall invest and manage trust assets as a prudent investor would."); Conn. Gen. Stat. Ann. § 45a-541b(a) (West 2004). Prudent individuals can and often do seek professional assistance when making investment decisions, especially if they have substantial assets or seek to accomplish difficult financial goals. In fact, a wealthy, demanding individual with complex financial goals may well have a much greater need for professional investment advice than a small trust with simple financial goals.

Petitioner asserts (Br. 8-10, 18) that trusts may have investment objectives that differ from those of many individuals. For example, a trustee may be required to

balance the needs of income beneficiaries and principal beneficiaries. But individuals commonly face similar investment choices, and are forced to made tradeoffs between income generation and growth of capital in determining how to invest their assets. See, *e.g.*, Geoffrey A. Hirt et al., *Investment Planning for Financial Professionals* 137 (2006) (distinguishing between investment strategies intended to "generate an immediate and ongoing flow of cash" and those "with the objective of capital appreciation"). Individuals may well seek investment advice to help them balance those tradeoffs. Moreover, even if the *content* of the advice obtained by a particular trust might differ from the content of the advice that would be provided to a particular individual, that does not mean that the *fees* for the advice are somehow different in kind from the fees that would be paid by an individual. Any competent investment advisor will tailor the content of his or her advice to the unique needs of each individual or institutional client. See James W. Bronson et al., *Managing Individual Investor Portfolios, in Managing Investment Portfolios: A Dynamic Process* 20, 20 (John L. Maginn et al. eds., 2007) (noting that "[i]ndividual investors have diverse investment objectives, time horizons, and perceptions of risk"). But the fees paid for all such advice are appropriately categorized in the same manner for tax purposes. Because an individual can obtain the same kind of advice as a trust, and can pay for it in the same way, the fees for that advice cannot be characterized as an expense that would not have been incurred if the property were not held in trust.

3. Petitioner further argues (Br. 48-50) that it should prevail under the interpretation adopted by the Fourth and Federal Circuits because individuals do not com-

monly pay for investment advice. But every court that has considered that factual question in construing Section 67(e) has either recognized that individuals commonly incur costs for outside investment advice or stated that it would be prudent for them to do so. See Pet. App. 27a-28a; *Scott*, 328 F.3d at 140; *Mellon Bank*, 265 F.3d at 1281; *O'Neill*, 994 F.2d at 304. Indeed, this Court has described the "cost of investment counsel or of investment services" as an example of "typically ordinary expenses" for an individual or an institutional asset manager. *Deputy* v. *DuPont*, 308 U.S. 488, 496-497 (1940). And even amicus curiae American Bankers Association acknowledges in its brief (Br. 6) that "individual investors often seek professional investment advice."

In any event, petitioner is in no position to make its factual argument. With exceptions not relevant here, the taxpayer bears the burden of proof on factual issues in the Tax Court. See Tax Ct. R. 142(a); *Welch* v. *Helvering*, 290 U.S. 111, 115 (1933); but cf. 26 U.S.C. 7491. In the proceeding below, petitioner acknowledged the standard employed by the Fourth and Federal Circuits, but presented no evidence to support its assertion that individuals do not commonly pay for investment advice. Thus, even under the interpretation adopted by the Fourth and Federal Circuits, petitioner cannot prevail on this record.

### C. Petitioner's Weak Causation Test Is Inconsistent With The Text Of Section 67(e)(1)

Petitioner contends (Br. 22) that the statute requires an inquiry into whether an expense was "caused by the fact that the property was held in the trust." According to petitioner, investment advice fees are "caused" by the fact that property is in trust, because they are "incurred in fulfillment of the trustee's fiduciary obligation," re-

gardless of whether they would have been incurred in the absence of a trust. *Ibid.* Petitioner's proposed test is inconsistent with the statute, and it would be unworkable in practice.

Petitioner's interpretation of Section 67(e)(1) is essentially the same as that set forth by the Sixth Circuit in *O'Neill* v. *Commissioner*, *supra*; see Action on Decision, No. CC-1994-06, 1994 WL 805239 (IRS Sept. 12, 1994) (expressing the IRS's disagreement with, and nonacquiescence in, the Sixth Circuit's interpretation). The court in *O'Neill* concluded that the investment-advice fees were incurred "because the property was held in trust." 994 F.2d at 304. The court stated that a trustee has a duty to manage trust assets under a prudent-investor standard, and that professional assistance may be warranted if he or she lacks experience in investing large sums of money. *Ibid.* The fees for that advice were therefore "necessary to the continued growth" of the trust and "caused by the fiduciary duties" of the trustees. *Ibid.*

There is no support, however, either in the words of Section 67(e)(1) or in the grammatical context in which those words are used, for the conclusion that full deductibility turns on whether a trustee was fulfilling a fiduciary duty when he or she incurred a particular cost. In the first place, the statute does not mandate a factual inquiry into whether the expense flows from the trust. Rather, it mandates a counterfactual inquiry into whether the expense would not have been incurred in the absence of a trust. Moreover, petitioner's proposed construction would read the critical words right out of the statute. A requirement that expenses be related to the discharge of fiduciary duties is what the first clause of Section 67(e)(1) demands, because it requires a con-

nection between the cost incurred and trust administration. The second clause of Section 67(e)(1) does not redundantly ask whether a trustee merely incurred a cost in the exercise of his or her fiduciary duty, but instead asks whether the trust was the sole cause of the expense, *i.e.*, whether the expense "would not have been incurred" in the absence of the trust. A weak causal connection between the trustee's fiduciary obligation and the cost is not enough to escape the 2% floor; instead, only expenses uniquely connected to the trust—those that would not have been incurred absent a trust—escape the floor. Prudent individuals acting to protect their own interests will often incur the very same costs that a trustee would be motivated to incur in fulfillment of his or her fiduciary obligations, so a focus on costs causally linked to those obligations simply ignores the statutory text. See *Mellon Bank*, 265 F.3d at 1280 ("Words such as 'legal obligations,' 'trustee fees,' and 'fiduciary responsibility' are not found within section 67(e)(1).").[9]

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[9] Petitioner's weak causation test also must be rejected because it improperly changes the subjunctive mood of the second clause to the indicative mood. See *Sutton* v. *United Air Lines, Inc.*, 527 U.S. 471, 482 (1999); *United States* v. *Wilson*, 503 U.S. 329, 333 (1992) ("Congress' use of a verb tense is significant in construing statutes."). The second clause of Section 67(e)(1) does not ask why a trustee incurred a cost or whether a cost was "incurred because the property was held in trust." *O'Neill*, 994 F.2d at 304; see Pet. Br. 22. Instead, it asks whether the cost was one "which would *not* have been incurred *if* the property *were not* held in such trust." 26 U.S.C. 67(e)(1) (emphases added). See *Scott*, 328 F.3d at 140 ("[T]he second [clause] of § 67(e)(1) does not ask whether costs are commonly incurred in the administration of trusts. Instead, it asks whether costs are commonly incurred *outside* the administration of trusts."). The second clause requires more than a weak causal connection. Only expenses that would not have been incurred absent the trust escape the 2% floor.

Moreover, so long as trustees are acting in good faith, they are always fulfilling their fiduciary duty when they incur expenses in connection with the administration of a trust. Thus, under petitioner's test, all expenses incurred by a trustee in connection with the administration of a trust would be fully deductible. That result, however, would reduce the second clause of Section 67(e)(1) to surplusage. *Scott*, 328 F.3d at 140 ("[W]e would, by holding that a trust's investment-advice fees were fully deductible, render meaningless the second requirement of § 67(e)(1). All trust-related administrative expenses could be attributed to a trustee's fiduciary duties, and the broad reading of § 67(e)(1) urged by the taxpayers would treat as fully deductible any costs associated with a trust.").

According to petitioner (Br. 22-23), its proposed test would not allow all administrative costs to escape the 2% floor. Petitioner offers the cost of routine maintenance of real property as an example of a cost that, it claims, would be subject to the floor even under its test. Br. 23. While the cost of routine maintenance of real property is a valid administrative cost, it is nevertheless "caused" by actions taken by the trustee in furtherance of his or her fiduciary duties. On petitioner's theory, a trustee who incurred expenses to maintain real property held in a trust would be discharging the fiduciary duty to preserve trust assets. See Restatement (Second) of Trusts § 176, at 381 (1959) ("The trustee is under a duty to the beneficiary to use reasonable care and skill to preserve the trust property."). The expense of maintenance would thus escape the 2% floor under petitioner's rule.[10]

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[10] Amicus curiae the Florida Bar suggests (Br. 26-27) that bad debts and costs passed down from pass-through entities are examples of costs that would be subject to the 2% floor under petitioner's test. The loss

Petitioner contends (Br. 38-39) that its interpretation is supported by the principle that ambiguities in tax statutes must be construed against the government. But that supposed canon has not been employed by this Court in decades, and it is inconsistent with modern principles of statutory construction and administrative deference. And even if it might have some vestigial force in limited circumstances, it would have no application here: under principles of statutory construction that this Court *has* reaffirmed in recent decades, Section 67(e)(1) must be given a narrow construction, both because it creates an exception to the general statutory policy of Section 67(e) and because tax deductions are a matter of legislative grace. See p. 12, *supra*. Section 67 establishes the terms under which certain miscellaneous expenses can be deducted, and it should be read in its entirety in accordance with those long-standing principles. Petitioner errs in suggesting that a statutory exception authorizing a broader deduction than would otherwise be available should be interpreted as if it were a statute imposing a tax.

### D. Legislative History Furnishes Additional Support For The Decision Of The Court Of Appeals

#### *1. Subjecting investment-advice fees to the 2% floor is consistent with Congress's goals in enacting the 1986 reforms*

Because the application of Section 67(e)(1) to investment-advice fees is clear, it is not necessary to refer to legislative history. See *Department of Hous. & Urban*

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suffered from a bad debt, however, is not a cost incurred "in connection with the administration of [a] trust." And costs passed down from pass-through entities are "caused" by the trustee's decision to invest in (or to retain the trust's investments in) those entities.

*Dev.* v. *Rucker*, 535 U.S. 125, 132 (2002). In any event, the legislative history is fully consistent with the statutory text. Although there is no meaningful discussion of Section 67(e)(1) itself in the legislative history, an examination of the broader history of the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085, demonstrates that subjecting investment-advice fees to the 2% floor is consistent with the intent of Congress underlying the 1986 reforms.

In enacting the Tax Reform Act of 1986, Congress sought to increase the fairness, simplicity, and economic efficiency of the tax system. It believed that closing loopholes and lowering marginal rates would simplify the Code, ensure that similarly situated individuals pay similar amounts of tax, and make economically inefficient tax-avoidance schemes less attractive. H.R. Rep. No. 426, 99th Cong., 1st Sess. 54-61 (1985) (*1985 House Rep.*); see S. Rep. No. 313, 99th Cong., 2d Sess. 3-8 (1986) (*1986 Senate Rep.*). Congress refused, however, to place simplicity ahead of fairness and accuracy, recognizing that complexity was sometimes necessary to prevent sophisticated taxpayers from unfairly reducing their taxes. *1986 Senate Rep.* 4; see *1985 House Rep.* 58. Those goals are reflected in the 2% floor of Section 67(a) and in amendments to other Code sections governing the taxation of trusts.

The 2% floor was part of Congress's simplification efforts. Congress believed that the prior-law treatment of miscellaneous itemized deductions caused significant complexity because it required extensive taxpayer recordkeeping and IRS auditing for relatively small deductions. The 2% floor, Congress believed, would relieve taxpayers of the burden of recordkeeping unless they expected miscellaneous expenditures in excess of

that threshold. *1985 House Rep.* 109-110; *1986 Senate Rep.* 78-79.

Petitioner suggests (Br. 24-25, 32-33) that Congress's objective in enacting Section 67 was to limit deductions for personal expenses. Although that was one aim of the statute, it was not Congress' only goal. Rather, the Senate Finance Committee stated that "allowance of [miscellaneous itemized] deductions under present law fosters significant complexity," that "*some* of these expenses have characteristics of voluntary personal expenditures," and that "*some* miscellaneous expenses allowable under present law are sufficiently personal in nature that they would have been incurred apart from any business or investment activities of the taxpayer." *1986 Senate Rep.* 78-79 (emphasis added). Consistent with Congress's broader goals, Section 67(b) does not exclude from the 2% floor—and 26 C.F.R. 1.67-1T(a) explicitly makes subject to the floor—expenses that are directly related to earning, investing, managing, and reporting income, including continuing education, professional uniforms, investment advice, and tax advice. Those expenses are not personal in nature.

Congress also recognized that "[t]he present rules relating to the taxation of trusts and estates permit the reduction of taxation through the creation of entities that are taxed separately from the beneficiaries or grantor of the trust or estate." *1986 Senate Rep.* 867. Congress sought to reduce the tax benefit of placing assets in trust in order to split income between a trust and its beneficiaries, primarily by setting the tax rates for trusts so that little income could be sheltered at the lower rates. See 26 U.S.C. 1(e); *1986 Senate Rep.* 868. Contrary to petitioner's argument (Br. 36-37), making the 2% floor for miscellaneous itemized deductions ap-

plicable to trusts (with an exception for trust-related administrative expenses that would not have been incurred if the property were not held in trust) advances that goal because it prevents trusts from fully deducting the same expenses that individuals cannot fully deduct. See *Scott*, 328 F.3d at 138-140; *Mellon Bank*, 265 F.3d at 1281. Moreover, treating items like the expense of investment advisors the same for individuals and trusts —*i.e.*, equally subject to the 2% floor—avoids creating artificial tax-related incentives to form trusts. In particular, it eliminates the ability of an individual to obtain full deductibility for investment advice simply by placing assets in a trust.[11]

***2. An examination of the bills culminating in the enactment of 26 U.S.C. 67(e) refutes petitioner's argument that the provision was intended to apply only to expenses incurred by trusts from pass-through entities***

Based on committee materials and the bills leading up to the present version of 26 U.S.C. 67(e), petitioner argues (Br. 33-36) that the second clause of Section 67(e)(1) was intended by Congress only to prevent trusts from fully deducting expenses passed down to them from so-called "pass-through entities." Even if that were true, it would not justify ignoring the statutory text, which sweeps more broadly. See *Oncale* v. *Sundowner Offshore Servs., Inc.*, 523 U.S. 75, 79 (1998) ("[S]tatutory prohibitions often go beyond the principal

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[11] Petitioner errs in describing (Br. 37) Senate Report No. 313 as "inapposite." The report demonstrates that the provisions relating to trusts in the Tax Reform Act of 1986 were motivated in part by Congress's general interest in "eliminat[ing] or significantly reduc[ing]" the "tax benefits which result from the ability to split income between a trust or estate and its beneficiaries," *1986 Senate Rep.* 868, an interest that is promoted by applying the 2% floor to trusts.

evil to cover reasonably comparable evils, and it is ultimately the provisions of our laws rather than the principal concerns of our legislators by which we are governed."). In any event, petitioner's interpretation of the legislative history is incorrect.

Pass-through entities generally consist of partnerships, grantor trusts, nonpublic mutual funds, and corporations that elect to be taxed under Subchapter S of the Code. See 26 C.F.R. 1.67-2T(a). Those organizations do not pay income taxes at the entity level. Instead, they pass their income down to ultimate taxpayers, usually individuals, who report that income on their individual returns and take it into consideration in calculating their income taxes. See 26 C.F.R. 1.67-2T.

Estates and ordinary trusts, like petitioner, must pay taxes on their income. See 26 U.S.C. 1(e). That income can come from a variety of sources, including investments in pass-through entities. In calculating their taxable income, however, trusts and estates generally can deduct the income that they distribute to their beneficiaries. See 26 U.S.C. 651, 661. Thus, trusts and estates are ultimate taxpayers that in some ways function like pass-through entities.

In the original House bill, 26 U.S.C. 67 imposed a floor on miscellaneous itemized deductions for individuals while allowing trusts and estates, as ultimate taxpayers, to deduct all of their administrative costs. H.R. 3838, 99th Cong., 1st Sess. § 132 (1985). The concern then arose that individuals could use pass-through entities to avoid the 2% floor. See *Issues Relating to Pass-through Entities: Hearings Before the Subcomm. on Select Revenue Measures of the House Comm. on Ways and Means*, 99th Cong., 2d Sess. 1-3 (1986). Without some restriction on pass-through entities, an individual

could deduct the full cost of investment advice by placing his or her investments in a pass-through entity, deducting the cost of the advice at the entity level in calculating the net investment income subject to pass-through treatment, and reporting only the net investment income on his or her individual return.

To address that problem, Congress enacted 26 U.S.C. 67(c), which directs the Secretary of the Treasury to adopt regulations prohibiting "the indirect deduction through pass-thru entities of amounts which are not allowable as a deduction if paid or incurred directly by an individual."[12] Under 26 C.F.R. 1.67-2T, which implements Section 67(c), pass-through entities must separately pass down income and expense items characterized in such a way that the ultimate taxpayer knows which expenses must be placed under the floor. Congress has exempted from those reporting requirements certain pass-through entities that pose little risk of abuse, including trusts and estates when they function like pass-through entities. 26 U.S.C. 67(c)(3).

Congress's decision to add Section 67(c), however, created problems with the taxation of trusts and estates as ultimate taxpayers. If a trust were allowed to deduct all of its administrative costs, then it, unlike an individual, could fully deduct the cost of investment advice passed down to it from pass-through entities in which the trust had invested. That result was avoided by the addition of the second clause of 26 U.S.C. 67(e)(1), which limits the exemption from the 2% floor to costs "which

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[12] Petitioner relies (Br. 35) on a Conference Report that, it says, explains "the second prong of § 67(e)." But the relevant portions of the report—which refer to the promulgation of regulations addressing pass-through entities—relate to Section 67(c), not to Section 67(e). See 2 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. 34 (1986).

would not have been incurred if the property were not held in such trust or estate."

From that history, petitioner infers that the second clause of Section 67(e)(1) should be limited to restricting the deductibility of costs passed to a trust by a pass-through entity. That interpretation is difficult to reconcile with petitioner's own reading of the statutory text: according to petitioner (Br. 23), its test would subject to the 2% floor some costs that are not associated with pass-through entities. In any event, as the court of appeals observed, "[i]f Congress's only purpose had been to restrict the ability of trusts as ultimate taxpayers to deduct fully their share of the administrative costs of pass-through entities in which they had invested," it could easily have drafted Section 67(e)(1) to achieve that result. Pet. App. 18a. For example, it could simply have provided for full deductibility of administrative costs "which are not pass-through costs restricted under section 67(c)." *Ibid.* Congress did not do so, and the broader language that it employed must be given effect.

Limiting the reach of the second clause of Section 67(e)(1) to pass-through items would also create tax avoidance opportunities similar to those that Section 67(c) was designed to eliminate. Just as Section 67(c) prevents individuals from placing assets in pass-through entities to obtain full deductibility for the cost of investment advice, the court of appeals' interpretation of the second clause of Section 67(e)(1) prevents trusts, as ultimate taxpayers, from pulling assets out of pass-through entities to obtain full deductibility for the cost of investment advice—quite possibly the same advice from the same advisors as before the transfer.

**E. Petitioner's Policy Arguments Lack Merit**

Finally, petitioner argues (Br. 40-41) that subjecting investment-advice fees to the 2% floor will harm the beneficiaries of trusts. Insofar as petitioner complains that the rule adopted by the court of appeals will "erode trust corpus," that is an objection that could be leveled against any tax on trusts. All taxes reduce the assets of those who are taxed.

Petitioner also suggests that the application of the 2% floor will cause trustees to eschew professional advice in an effort to reduce their trusts' tax liabilities. That is highly unlikely, as petitioner itself demonstrates. During the year 2000, petitioner held assets exceeding $2.2 million, and its adjusted gross income was $613,263. Pet. App. 22a-23a; J.A. 24-27. It paid $22,241 (1.0% of its assets and 3.6% of its income) for investment advice, and its failure to subject its deduction for that advice to the 2% floor resulted in a deficiency of only $4448 (0.2% of its assets and 0.7% of its income). Pet. App. 22a-23a. Even if a trust is in the highest income tax bracket (currently 35%, see 26 U.S.C. 1(e); 26 U.S.C. 1(i)(2) (Supp. IV 2004)), the additional tax caused by the application of the 2% floor will be, at most, 0.7% of the trust's income. No responsible trustee would risk breaching his or her fiduciary duty by refraining from seeking investment advice merely to save such a small amount of tax.

## CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted.

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OCTOBER 2007

## APPENDIX

1. 26 U.S.C. 67 provides:

**2-percent floor on miscellaneous itemized deductions**

**(a) General rule**

In the case of an individual, the miscellaneous itemized deductions for any taxable year shall be allowed only to the extent that the aggregate of such deductions exceeds 2 percent of adjusted gross income.

**(b) Miscellaneous itemized deductions**

For purposes of this section, the term "miscellaneous itemized deductions" means the itemized deductions other than—

(1) the deduction under section 163 (relating to interest),

(2) the deduction under section 164 (relating to taxes),

(3) the deduction under section 165(a) for casualty or theft losses described in paragraph (2) or (3) of section 165(c) or for losses described in section 165(d),

(4) the deductions under section 170 (relating to charitable, etc., contributions and gifts) and section 642(c) (relating to deduction for amounts paid or permanently set aside for a charitable purpose),

(5) the deduction under section 213 (relating to medical, dental, etc., expenses),

(6) any deduction allowable for impairment-related work expenses,

(7) the deduction under section 691(c) (relating to deduction for estate tax in case of income in respect of the decedent),

(8) any deduction allowable in connection with personal property used in a short sale,

(9) the deduction under section 1341 (relating to computation of tax where taxpayer restores substantial amount held under claim of right),

(10) the deduction under section 72(b)(3) (relating to deduction where annuity payments cease before investment recovered),

(11) the deduction under section 171 (relating to deduction for amortizable bond premium), and

(12) the deduction under section 216 (relating to deductions in connection with cooperative housing corporations).

**(c) Disallowance of indirect deduction through pass-thru entity**

**(1) In general**

The Secretary shall prescribe regulations which prohibit the indirect deduction through pass-thru entities of amounts which are not allowable as a deduction if paid or incurred directly by an individual and which contain such reporting requirements as may be necessary to carry out the purposes of this subsection.

**(2) Treatment of publicly offered regulated investment companies**

**(A) In general**

Paragraph (1) shall not apply with respect to any publicly offered regulated investment company.

**(B) Publicly offered regulated investment companies**

For purposes of this subsection—

**(i) In general**

The term "publicly offered regulated investment company" means a regulated investment company the shares of which are—

(I) continuously offered pursuant to a public offering (within the meaning of section 4 of the Securities Act of 1933, as amended (15 U.S.C. 77a to 77aa)),

(II) regularly traded on an established securities market, or

(III) held by or for no fewer than 500 persons at all times during the taxable year.

**(ii) Secretary may reduce 500 person requirement**

The Secretary may by regulation decrease the minimum shareholder requirement of clause (i)(III) in the case of regulated investment companies which experience a loss of shareholders through net redemptions of their shares.

**(3) Treatment of certain other entities**

Paragraph (1) shall not apply—

(A) with respect to cooperatives and real estate investment trusts, and

(B) except as provided in regulations, with respect to estates and trusts.

**(d) Impairment-related work expenses**

For purposes of this section, the term "impairment-related work expenses" means expenses—

(1) of a handicapped individual (as defined in section 190(b)(3)) for attendant care services at the individual's place of employment and other expenses in connection with such place of employment which are necessary for such individual to be able to work, and

(2) with respect to which a deduction is allowable under section 162 (determined without regard to this section).

**(e) Determination of adjusted gross income in case of estates and trusts**

For purposes of this section, the adjusted gross income of an estate or trust shall be computed in the same manner as in the case of an individual, except that—

(1) the deductions for costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate, and

(2) the deductions allowable under sections 642(b), 651, and 661,

shall be treated as allowable in arriving at adjusted gross income. Under regulations, appropriate adjustments shall be made in the application of part I of subchapter J of this chapter to take into account the provisions of this section.

**(f) Coordination with other limitation**

This section shall be applied before the application of the dollar limitation of the second sentence of section 162(a) (relating to trade or business expenses).

2. 26 U.S.C. 212 provides:

**Expenses for production of income**

In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year—

(1) for the production or collection of income;

(2) for the management, conservation, or maintenance of property held for the production of income; or

(3) in connection with the determination, collection, or refund of any tax.

3. 72 Fed. Reg. 41,243-41,245 (2007) provides:

**DEPARTMENT OF THE TREASURY**

**Internal Revenue Service**

**26 CFR Part 1**

**[REG-128224-06]**

**RIN 1545-BF80**

**Section 67 Limitations on Estates or Trusts**

**AGENCY:** Internal Revenue Service (IRS), Treasury.

**ACTION:** Notice of proposed rulemaking and notice of public hearing.

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**SUMMARY:** This document contains proposed regulations that provide guidance on which costs incurred by estates or non-grantor trusts are subject to the 2-percent floor for miscellaneous itemized deductions under section 67(a). The regulations will affect estates and non-grantor trusts. This document also provides notice of a public hearing on these proposed regulations.

**DATES:** Written and electronic comments must be received by October 25, 2007. Outlines of topics to be discussed at the public hearing scheduled for November 14, 2007 must be received by October 24, 2007.

**ADDRESSES:** Send submissions to CC:PA:LPD:PR (REG-128224-06), room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-128224-06), Courier's Desk,

Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC, or sent electronically via the Federal eRulemaking Portal at *http://www.regulations.gov/* (indicate IRS and REG-128224-06). The public hearing will be held in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

**FOR FURTHER INFORMATION CONTACT:** Concerning the proposed regulations, Jennifer N. Keeney, (202) 622-3060; concerning submissions of comments, the hearing, or to be placed on the building access list to attend the hearing, Richard A. Hurst, (202) 622-7180 (not toll-free numbers).

**SUPPLEMENTARY INFORMATION:**

**Background**

This document contains proposed amendments to 26 CFR part 1. Section 67(a) of the Internal Revenue Code (Code) provides that, for an individual taxpayer, miscellaneous itemized deductions are allowed only to the extent that the aggregate of those deductions exceeds 2 percent of adjusted gross income. Section 67(b) excludes certain itemized deductions from the definition of "miscellaneous itemized deductions." Section 67(e) provides that, for purposes of section 67, the adjusted gross income of an estate or trust shall be computed in the same manner as in the case of an individual. However, section 67(e)(1) provides that the deductions for costs paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such estate or trust shall be treated as allowable in arriving at adjusted gross income. Therefore, deduc-

tions described in section 67(e)(1) are not subject to the 2-percent floor for miscellaneous itemized deductions under section 67(a).

United States courts of appeals have interpreted the language of section 67(e)(1) differently in determining whether costs incurred by trustees are subject to the 2-percent floor. The issue in each case has been whether the trust's costs (specifically, investment advisory fees) "would not have been incurred if the property were not held in such trust or estate." In O'Neill v. Commissioner, 994 F.2d 302 (6th Cir. 1993), the Court of Appeals for the Sixth Circuit held that investment advisory fees paid for professional investment services were fully deductible under section 67(e)(1) where the trustees lacked experience in managing large sums of money. The court found that, under state law, the trustee was required to engage an investment advisor to meet its fiduciary obligations and to incur fees that the trust would not have incurred if the property were not held in trust. The court held that estate or trust expenditures that are necessary to meet specific fiduciary obligations under state law are not subject to the 2-percent floor. In contrast, in *Mellon Bank, N.A. v. United States*, 265 F.3d 1275 (Fed. Cir. 2001), *Scott v. United States*, 328 F.3d 132 (4th Cir. 2003), and *Rudkin v. Commissioner*, 467 F.3d 149 (2d Cir. 2006), the courts held that investment advisory fees are subject to the 2-percent floor. These courts read the language of section 67(e)(1) differently than the Sixth Circuit. Specifically, the courts in *Scott* and *Mellon Bank* concluded that a trust expense is subject to the 2-percent floor if it is an expense "commonly" or "customarily" incurred by individuals; and the court in *Rudkin* looked to whether

such an expense was "peculiar to trusts" and "could not" be incurred by an individual.

The result of this lack of consistency in the case law is that the deductions of similarly situated taxpayers may or may not be subject to the 2-percent floor, depending upon the jurisdiction in which the executor or the trustee is located. The IRS and the Treasury Department believe that similarly situated taxpayers should be treated consistently by having section 67(e)(1) construed and applied in the same way in all jurisdictions. The proposed regulations are intended to provide a uniform standard for identifying the types of costs that are not subject to the 2-percent floor under section 67(e)(1).

**Explanation of Provisions**

These proposed regulations provide that costs incurred by estates or non-grantor trusts that are unique to an estate or trust are not subject to the 2- percent floor. For this purpose, a cost is unique to an estate or trust if an individual could not have incurred that cost in connection with property not held in an estate or trust. To the extent that expenses paid or incurred by an estate or non-grantor trust do not meet this standard, they are subject to the 2-percent floor of section 67(a). (Neither section 67 nor this rule applies to expenses that are excluded under section 67(b) from the definition of miscellaneous itemized deductions, or to expenses related to a trade or business.)

Under the proposed regulations, whether costs are subject to the 2- percent floor on miscellaneous itemized deductions depends on the type of services provided, rather than on taxpayer characterizations or labels for

such services. Thus, taxpayers may not circumvent the 2-percent floor by "bundling" investment advisory fees and trustees' fees into a single fee. The regulations provide that, if an estate or non-grantor trust pays a single fee that includes both costs that are unique to estates and trusts and costs that are not, then the estate or non-grantor trust must use a reasonable method to allocate the single fee between the two types of costs. The regulations also provide a non-exclusive list of services for which the cost is either exempt from or subject to the 2-percent floor. The IRS and the Treasury Department invite comments on whether any safe harbors or other guidance, concerning allocation methods or otherwise, would be helpful.

**Proposed Effective Date**

The regulations, as proposed, apply to payments made after the date final regulations are published in the **Federal Register**.

**Special Analyses**

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because these regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking has been submitted to the Chief Counsel for Advocacy of the Small Business

Administration for comment on its impact on small business.

**Comments and Public Hearing**

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department request comments on the proposed rules, as well as their clarity and how they can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for November 14, 2007, beginning at 10 a.m. in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the **FOR FURTHER INFORMATION CONTACT** section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit written or electronic comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by October 24, 2007. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the schedule of speakers will be pre-

pared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

**Drafting Information**

The principal author of these regulations is Jennifer N. Keeney, Office of the Office of Associate Chief Counsel (Passthroughs and Special Industries).

**List of Subjects in 26 CFR Part 1**

Income taxes, Reporting and recordkeeping requirements.

**Proposed Amendments to the Regulations**

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

**PART 1—INCOME TAXES**

**Paragraph 1.** The authority citation for part 1 continues to read in part as follows:

**Authority:** 26 U.S.C. 7805 * * *

**Par. 2.** Section 1.67-4 is added to read as follows:

**1.67-4 Costs paid or incurred by estates or non-grantor trusts.**

(a) *In general.* Section 67(e) provides an exception to the 2-percent floor on miscellaneous itemized deductions for costs that are paid or incurred in connection with the administration of an estate or a trust not described in § 1.67-2T(g)(1)(i) (a non-grantor trust) and which would not have been incurred if the property were not held in such estate or trust. To the extent that a cost incurred by an estate or non-grantor trust is unique to

such an entity, that cost is not subject to the 2-percent floor on miscellaneous itemized deductions. To the extent that a cost included in the definition of miscellaneous itemized deductions and incurred by an estate or non-grantor trust is not unique to such an entity, that cost is subject to the 2-percent floor.

(b) *Unique.* For purposes of this section, a cost is unique to an estate or a non-grantor trust if an individual could not have incurred that cost in connection with property not held in an estate or trust. In making this determination, it is the type of product or service rendered to the estate or trust, rather than the characterization of the cost of that product or service, that is relevant. A non-exclusive list of products or services that are unique to an estate or trust includes those rendered in connection with: Fiduciary accountings; judicial or quasi-judicial filings required as part of the administration of the estate or trust; fiduciary income tax and estate tax returns; the division or distribution of income or corpus to or among beneficiaries; trust or will contest or construction; fiduciary bond premiums; and communications with beneficiaries regarding estate or trust matters. A non-exclusive list of products or services that are not unique to an estate or trust, and therefore are subject to the 2-percent floor, includes those rendered in connection with: Custody or management of property; advice on investing for total return; gift tax returns; the defense of claims by creditors of the decedent or grantor; and the purchase, sale, maintenance, repair, insurance or management of non-trade or business property.

(c) *"Bundled Fees."* If an estate or a non-grantor trust pays a single fee, commission or other expense for

both costs that are unique to estates and trusts and costs that are not, then the estate or non-grantor trust must identify the portion (if any) of the legal, accounting, investment advisory, appraisal or other fee, commission or expense that is unique to estates and trusts and is thus not subject to the 2-percent floor. The taxpayer must use any reasonable method to allocate the single fee, commission or expense between the costs unique to estates and trusts and other costs.

(d) *Effective/applicability date.* These regulations are proposed to be effective for payments made after the date final regulations are published in the **Federal Register.**

**Kevin Brown,**

*Deputy Commissioner for Services and Enforcement.*